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A real estate appraisal checklist: a better understanding of an appraisal's details ensures more meaningful appraisal reviews and compliance with heightened regulatory requirements. This article offers a checklist and discusses the requirements for the items on it

An appraisal is an assemblage of data, assumptions, calculations, discussions, analyses, opinions, presentation formats, and requirements that should result in the appraiser's credible opinion of market value. The credibility of that market value increases when both banker and appraiser follow best practices, which begin with federal appraisal regulations that also require adherence to the Uniform Standards of Professional Appraisal Practice (USPAP). (1)

A banker recently asked me if I had a checklist that loan officers could use to review appraisals quickly. I do not, because I believe it's more important to review appraisals meaningfully. Although several sections of USPAP do not apply to real estate, the 2004 edition consisted of 229 pages of small type. Regulations and the USPAP are both lengthy. So, while my checklist may not be as speedy as some may like, it does distill the regulations while capturing their essence.

Examples that I have seen of questionable appraisal credibility include the following:

* The bank accepts an appraisal ordered by the borrower (the bank does not have the legal authority to accept it).

* The appraiser describes the wrong property.

* The appraiser uses stale, comparable-sales data without showing why the stale data is meaningful.

* The appraiser makes a significant mathematical error in calculating a capitalization rate.

Recently, I came across an appraisal reviewed by a second appraiser. The originating appraiser stated that a party other than the borrower owned the real estate. He appraised the borrower's ownership interest, though, as fee simple. When I asked the loan officer about this seeming discrepancy, he said that the originating appraiser had obtained the ownership information from a legal service and not from title documents. By reviewing the preliminary title report, the bank found that the borrower had held title for several years. Neither the originating nor the reviewing appraiser had recognized this discrepancy between the statement of ownership and the appraised ownership interest.

I uncovered another credibility issue in May 2006 while reviewing a partially completed tract home project. The appraisal stated that the project would be completed and sold out by December 2005 and that it would have no models. In fact, however, not only was the project incomplete, but it had 10 models. The loan officer knew this, but neither the appraiser nor the review appraiser did, and the loan officer himself did not review the appraisal. Because the loan officer placed all responsibility for the review onto someone not as familiar with the project, the bank was using an appraisal with questionable credibility.

I have worked with more than a hundred banks and thousands of loan officers since the passage of FIRREA (Federal Institutions Reform, Recovery and Enforcement Act of 1989) prompted appraisal regulations. I have seen several appraisal-review checklists filled out to show that appraisals conform to regulations and to USPAP when, in fact, they do not. Some of these lenders did not have the training to review an appraisal for credibility.

Both regulations and USPAP have had recent major changes or interpretations.

* In September 2005, the federal banking regulators published the Interagency Frequently Asked Questions on Residential Tract Development Lending. This is a major interpretation and statement of the requirements for appraisals of residential tracts.

* On July 1, 2006, USPAP changed significantly--the biggest change in several years. The changes brought the scope of work requirement out of Standards Rule 1, expanded it, and created a separate Standards of Work Rule (SWR). It also moved other requirements around and deleted others. One bank's internal appraiser told me that he was disheartened by the USPAP changes. His external appraisers had only recently seemed to fully understand what he wanted, which was, most of the time, a complete-summary appraisal. That designation has now gone away. He said that he might instruct the appraisers that he now wants a summary appraisal as if the old complete-summary designation still existed. He is also thinking of printing a standard list of requirements. This, however, seems to defeat the purpose of the SWR, which is to require the appraiser to determine the level of data and analysis needed to produce a credible market value and to ensure that the reader understands that the appraised market value is credible. That requirement means the appraiser must better disclose the type and extent of analysis, rather than rely on the "complete" and "limited" appraisal labels.

Another bank's internal appraiser said that appraisers would now likely include fewer approaches (cost, comparable sales, and income). I am not sure about the validity of his option, because excluding an approach did and still does require justification. Over the years, I have seen many appraisals where the appraisers gave reasonable explanations for why an approach was not used.

If you use the checklist shown in this article, you should come to know whether an appraiser has followed best practices or not. Yes, it is far longer than most checklists, and completing it takes time you may think you do not have. Even if your bank contracts out reviews to professional reviewers, you still should understand the risk of your collateral. For an appraisal to comply with USPAP, the appraiser must present the information so that you understand it. Fortunately, most USPAP compliance issues in appraisals are relatively minor, and the appraised market values are still reasonably credible.

You would not want to use this entire checklist for some types of appraisals, though--for example, a standard-form appraisal of an owner-occupied single-family tract residence. In an appraisal of an existing tract SFR, you can, for example, focus the greater part of your attention on the sales comparables in the same tract. In a downward-trending housing market, however, you need to be careful that the appraiser has adequately captured market trends in the analysis.

In summary, when you use a thorough checklist, you can better understand whether an appraiser has used best practices, and it should help you better understand the risk of your collateral.

Real Estate Appraisal Checklist

Borrower:

Appraiser: On Approved List?
Y N

Date of Appraisal Report:

Date of Market Value:

Market Value As Is:

Market Value As Complete:

Market Value As Stabilized:

Property Type & Location:

Reviewed By:

Review Date:

Y = Yes, N = No

First Things First Y N

a. Did the bank or its agent order the appraisal?

b. Was the appraisal ordered by another financial institution?

c. Was the appraisal ordered by the borrower?

d. Does the appraiser have an interest in the property?

e. Does the description of the property in the appraisal match the description in the title documents?

f. Does the appraisal contain a scope of work adequate to produce credible assignment results?

g. Is the appraisal: Self contained? A summary? Restricted?

h. Does the appraiser state that the purpose of the appraisal is to estimate market value? Does the appraisal include the definition of market value and does it state the intended use and user(s)?

Y = Yes, N = No, NA = Not Applicable, NI = Not Included but Should Have Been

Y N NA NI

1. Did the appraisal correctly show the interest appraised? That is, is it fee simple (not leased to others), leased fee (has or will be leased to others), or leasehold estate (lessee's interest in the property)?

2. Was the regional and neighborhood analysis relevant to the subject property?

3. If the area is changing in character, were emerging trends fully explained?

4. a. Does the value reflect current zoning?

4. b. Does the value reflect a hypothetical rezoning?

5. Does the highest and best use reflect the legal, physical, and economic factors?

6. Does the project have competing projects and will competition create downward pricing pressure and/or slower sales or rentals?

7. a. Are site improvements in place?

7. b. If the site improvements are not fully in place, have they been extended to the lot line?

7. c. If the site improvements are not fully in place, are they a long way from the site?

Did the appraiser use:

8. a. The cost approach?

8. b. The sales-comparison approach?

8. c. The income approach?

If the loan involves development or construction

9. a. Did the appraiser review plans & specifications?

9. b. Have the plans & specifications been approved by governmental authorities?

10. Did the appraiser adequately show the contribution of the proposed improvements in determining the market value?

11. a. Did the appraiser use the developmental approach?

11. b. Did the appraiser discount the sale or rental of the completed

units back to an "as complete" value over the marketing time it takes to sell out or rent the project by discounting for selling costs, holding costs, operating costs, maintenance, and entrepreneurial profits?

11. c. Did the appraiser support reasonable marketing times and construction timeframes?

11. d. Did the appraiser value a construction or development project as a whole rather than appraise the value of individual units and add those values together?

In the cost approach

12. Were cost-to-complete estimates compared with industry standards, such as Marshall & Swift?

13. Did the appraiser develop the land value by using the sales-comparison techniques of 16. a.-6. g.?

14. If the appraisal is of or includes existing construction, did the appraiser deduct for functional and economic obsolescence or building deterioration?

In the income approach

15. a. If the property is an existing rental property, did the appraiser consider both historical and current operating results?

15. b. Did the appraiser use rental comparables that are both reasonably current and competitive with the subject property in the same market or submarket?

Did the appraiser consider

15. c. Projected revenue and expenses?

15. d. Rental concessions?

15. e. Future capital improvements?

15. f. Extraordinary or nonrecurring capital expenditures?

15. g. Existing reserves?

15. h. If the property is an existing multiple-tenant rental property or has multiple leases signed up, did the appraisal include rent rolls?

Did the appraiser use

16. a. For stabilized properties, a direct capitalization rate that has been reasonably selected and supported?

16. b. If a direct capitalization rate has been selected, is it a rate determined primarily by using competing, comparable properties?

16. c. For non-stabilized properties, is it a discounted cash flow analysis that selected and supported a yield rate, terminal capitalization rate, and cost of sales that are reasonable?

In the sales-comparison approach

17. a. Does it include an adjustment grid?

17. b. Were all adjustments adequately described with rationale?

17. c. Were all sales at arm's length to the subject?

17. d. Was any adjustment so substantial that you question the use of one or more of the comparables?

17. e. Were all of the comparables from the same competitive market or submarket as the subject?

17. f. Do all of the comparables have the same zoning as the subject?

17. g. If any or all of the comparables had different zoning from the subject, did the appraisal show them to have the same highest and best use as the subject?

18. a. If the subject property includes excess land, is the excess a separate parcel?

18. b. Does the excess land valuation adequately follow the sales comparison requirements of 16. a.-16. g.?

Did the appraiser

19. Adequately reconcile the quality and quantity of data used within each approach?

20. Analyze a contract of sale, option, or listing on the subject property, if there is one?

21. Separately value non-real-estate items (intangibles, personal property, and furnishings)?

22. Disclose and analyze prior sales within the last three years?

23. Include the current market value "as is"?
24. Adequately present the information, procedures, and reasoning that supports the analyses, opinions, and conclusions? Do you understand it?
25. Make any significant arithmetic error or create a significant inconsistency between data in one section and the purported same data in another section?
26. Adequately justify the exclusion of any information normally considered relevant?

VALUE CONCLUSIONS

Check One

And/Or Comment

[] The appraisal reasonably or fully conforms to regulations and USPAP, is mathematically correct, and the opinion of market value, as defined in 12 CFR 34.42(g), is credible.

[] The appraisal does not fully conform to regulations and/or USPAP and/or has minor errors or omissions, but the opinion of market value is credible nonetheless.

[] The appraisal does not fully conform to regulations and/or USPAP and/or has errors or omissions, but the opinion of market value would be credible if it were fully conforming and the errors corrected or omissions included. We will ask the appraiser to make it fully conforming and inclusive.

[] The appraisal significantly fails to conform to appraisal regulations and/or USPAP and/or has serious errors or omissions, and the opinion of market value is not credible. We will ask the appraiser to redo important parts of the appraisal.

Real Estate Appraisal Checklist Discussion and Sources

12 CFR 34 = Real estate and appraisal standards for national banks. References in the checklist are to these national-bank regulations, but all federal banking regulators have identical regulations.

IAEG = 10/27/94 Interagency Appraisal and Evaluation Guidelines (Regulatory)

FAQ = 9/8/05 Interagency Frequently Asked Questions on Residential Tract Development Lending (Regulatory)

USPAP = Uniform Standards of Professional Appraisal Practice as of July 1, 2006

SR = USPAP Standards Rule

SMT = USPAP Statement on Appraisal Standards

SWR = USPAP Scope of Work Rule

TARE = The Appraisal of Real Estate, 10th Ed., Appraisal Institute

Dates 12 CFR 34.42(g) requires that the market value be of a specific date. SWR requires an effective date of value.

a.-c. 12 CFR 34.45(b)(1) requires that the bank or its agent order the appraisal. 12 CFR 34.45(b)(2) allows an exception if the bank uses an appraisal prepared for another financial institution and if the bank reviews it for compliance with the regulations. The (b)(1)regulation prohibits the bank's use of an appraisal ordered by the borrower. In legal terms, using an appraisal ordered by the borrower is an "ultra vires" act. That is, the bank does not have the authority to accept it. This includes an appraiser readdressing to the bank an appraisal that was ordered by the borrower. SMT-10(B)(2) also addresses this as a violation of the USPAP Ethics Rule.

d. While the USPAP Ethics Rule does not prohibit the appraiser from having an interest in the subject property, 12 CFR 34.45(b)(1 and 2)(i) require that the appraiser have no direct or indirect interest in the property. This is reiterated in IAEG. SMT-10(B)(1) requires disclosure but states that accepting such an assignment violating the 12 CFR 34.45 prohibition violates USPAP's Supplemental Standards Rule.

e. SR 1-2(e) requires the disclosure of the property's location and physical, legal, and economic attributes. One purpose is to make sure that the property appraised is, or will be, the bank's collateral and lets the bank know what the "as is" nature of the property really is. For a locational description, appraisers often use the APN or address.

f. In a recent change to USPAP, the new SWR now requires that the appraiser state the scope of work. The old SR 1-2(f) required the appraiser to identify and have sound reasons for the scope of work. The new SWR requirement is again stated in SR 2-2(a-c)(vii). If the appraisal is prepared for another financial institution, the bank needs to review the scope of work to make sure it meets the bank's needs.

g. The highest required level of data, analyses, and rationale of opinions and conclusions required by SR 2-2 is in a self-contained appraisal. A summary appraisal will have some of the data, analyses, and rationale of opinions and conclusions to be in summary form, but the appraiser must still adequately and understandably present and explain them. A restricted appraisal should include a statement of appraisal procedures followed, the value opinion, conclusions reached, and a statement that the workfile is available for inspection and that the conclusions may not be properly understood without information in the workfile. IAEG states that banks should not often use restricted appraisals.

h. SR 2-2 (a-c)(v) requires the appraiser to state the type and definition of value and cite the source of the definition. Market value is required by and defined in 12 CFR 34.42(g). Note: for a loan used to purchase a property, 12

CFR 34.62(d)(5) requires that the value used for the LTV calculation is the lower of "as is" market value or the purchase price. SR 2-2 (a-c)(i & ii) expanded by SMT-9 requires that the appraiser identify the intended use and intended users.

1. SR 1-2(e)(ii) requires that the appraisal identify the real property interest to be valued. A leasehold estate, for example, means that the appraisal needs to separate out the value of the land.

2.-3. SR 1-3(a) requires a discussion of market area economics and trends.

4. a.-4. b. The IAEG requires that the appraised current market value include current zoning. SR 1-3(a) requires that the appraiser discuss existing land use regulations and probable modifications. SR 1-2(e)(i) requires that the appraiser disclose the legal and economic attributes while SMT-10 D(1) also requires this disclosure. 10 D(2) requires that the appraiser disclose the use of a hypothetical condition or extraordinary assumption.

5. SR 1-3(b) requires that the opinion of highest and best use include the legal, physical, and economic factors.

6. SR 1-3(a) requires that the appraiser analyze economic supply and demand and market conditions. Some appraisals fail to recognize that competition may cannibalize sales or rentals rather than be neutral.

7. a.-7. c. SR 1-4(f) requires that the appraiser analyze the effect on value of the anticipated improvements on or off the site.

8. a.-8. c. SR 1-1(a) requires that the appraiser use those recognized methods and techniques to produce a credible market value. SR 2-2(a-c) (viii) states that the appraiser must explain the non-use of any of the cost, sales, or income approaches. SMT-10(C)(3) states that excluding a method may violate SR 2-2(a & b)(viii) and that the expectation includes what the appraiser's peers would provide. SWR and SMT-10(C)(3) extend this expectation to intended users. SR 1-6(b) requires reconciliation of the applicability or suitability of approaches.

9. a.-9. b. SR 1-2(e)(v) comment requires that the appraiser review the plans and specifications.

10. SR 1-4(f) requires that improvements be appraised for their contribution to value.

11. a.-11. d. 12 CFR 34.44(c) combined with 12 CFR 34.42(l) requires that the appraiser analyze and report appropriate deductions and discounts for construction and developments (includes properties to be leased and tract developments where five or more units are constructed as a single development). The appraisal industry's handbook, TARE (p. 327), states that entrepreneurial profits are a cost of development. The IAEG requires the appraiser to deduct holding costs, marketing costs, and entrepreneurial profits for individual units, houses, or lots. Typical holding costs would include property taxes, insurance, and maintenance. These same guidelines also explain that, for proposed and rehabilitated rental units, deductions and discounts also include leasing commissions, rental losses, and tenant improvements. In the FAQ # 8, "unit" also includes a condominium residence. SMT-2 states that the discounted cash flow method is an appropriate method for development and proposed construction. SR 1-1(a) requires that the appraiser use recognized methods to produce a credible appraisal. Using the discounting method for developments is also discussed in SMT-10(E)(5), and it requires discounting through the completed unit absorption period to include cash flows, market risk, and market trends--not only the time value of money. Discounting expected sales prices during the marketing (absorption) period by selling costs, holding costs, entrepreneurial profits, etc. back to the time of completion of the project produces a prospective "as complete" value. USPAP's Advisory Opinion 7 discusses market time and describes it as an opinion of the amount of time it might take to sell the real-property interest at the concluded market value. For multi-tenant rental properties, the stabilized net operating income divided by the capitalization rate produces an "as stabilized" value. The stabilization period is that time after completion of construction when the property's existing conditions are expected to continue over the economic life of the property. The expected time to construct and sell or rent a project can make a considerable difference in the discounted value. SR 1-4(e) requires that the appraiser analyze the effect on value on the assemblage of the component parts and not solely add together the component parts. SMT-10(E)(3) states that the market value of a tract development project of 5 or more units is not the sum of the retail values of the individual units. The FAQ updated some requirements to be more in line with the way developments are actually financed and in line with actual risk. The discounting requirement for tracts of five or more units can exclude presold units from the count. Presold, though, requires that the contract is binding, the deposit is substantial and nonrefundable, and the bank has documented the contract and obtained a written pre-qualification or commitment for permanent financing. The appraisal itself may be of the individual units and not discounted if the starts are financed as individual units. The bank also needs to demonstrate, independently of the borrower and the bank's loan production staff, that the units are likely to be built and sold within one year. In this case, the value for LTV purposes is the lower of appraised market value or the borrower's actual development and construction costs. If the financing is under a revolving line, the bank may use individual unit appraisals if the bank limits the number of construction starts and finished units, unsold homes in the borrowing base, and if the bank also satisfies the one year-individual unit completion requirement. For a revolving line LTV, the loan amount is the outstanding balance plus undisbursed commitment divided by the lower of actual construction and development cost or market value of the completed units under construction multiplied by the percentage of completion. A standard discounted appraisal is required if the borrowing base includes developed lots or raw land to be developed into lots.

12. SR 1-4(b)(i-iii) requires that the appraiser examine comparable cost data to estimate the cost new of improvements and to estimate the difference between the cost new and the present worth of the improvements. Marshall & Swift, for example, is one source of estimating construction costs with geographic adjustments.

13. Appraisers occasionally overlook that land value per square foot changes with size. Above a certain size, the value per square foot decreases. Appraisers can use Excel[R], for example, to create a table of size of parcel vs. price per square foot. They can then graph the data on a scatter plot. This technique is most useful when the sizes of the comparable parcels are considerably different from the subject.

14. TARE (pp. 343-365) has a good discussion of the effects of economic-age depreciation, physical deterioration, and the different kinds of obsolescence. Some are curable and some are not, but the replacement cost method should include their effects.

15. a.-15. h. SR 1-4(c) combined with SMT-2 requires that the appraiser analyze market rental data, market operating expenses, market capitalization rates or discounts, and projections of future rent and expenses, then weigh historical information and existing information about current and potential competition. If the "market" comparable properties are not competitive with each other and not in or of the same condition, construction, appearance, highest and best use, zoning, market, or submarket as the subject, they may not be truly comparable. TARE (p. 534) shows that management fees and replacement costs should be included. Management fees should be included because the bank would have to incur them if it were to foreclose on the property.

16. a.-16. c. SMT-2 requires that market value discounted cash flow analyses use market derived data, including real estate and capital market derived discount rates. Ideally, the appraiser should derive discount rates from analysis of the local market and use other methods used for verification. Local-market data might be sparse, however, and the other methods might become primary. Some appraisals include the effect of entrepreneurial profits in the discount rate rather than subtract it from net operating income. TARE (p. 468) states that capitalization rates should be derived from comparable sales when possible. A capitalization rate is for stabilized (or assumed to become stabilized) rental properties and is a form of a discount rate. SMT-2 also requires, when the discounted value of rental properties includes a final sales amount of the rental project sometime in the future, that the reversion capitalization rate be based on the real estate type, age and condition, cash flow characteristics, and related factors. The NOI in the year of sale divided by the analyzed reversion capitalization rate produces the estimated reversion sale amount. This reversion sales amount becomes part of the cash flow stream subject to discounting back to present value.

17. a.-17. g. SR 1-4(a) states that the appraiser must analyze comparable sales. TARE (pp. 152-153) discusses some of the requirements of comparables. They should be competitive to the subject within the same market or submarket. Large adjustments leave a question of whether a comparable is, indeed, comparable. An adjustment grid is nice but is not required by regulations.

18. a.-18. b. SR 1-2(e)(i) requires that the appraiser disclose the legal and economic attributes of the property while SR 1-2(g) requires that the appraiser disclose the use of a hypothetical condition. The question becomes: if the bank were to foreclose on the property, could the "excess land" be sold as a separate parcel or would it have to be sold as part of the main parcel with the possibility that it would not significantly add to value?

19. SR 1-6(a) requires reconciliation of the quality and quantity of data available and analyzed.

20. SR 1-5(a) requires analysis of any contract of sale, option, or listing.

21. SR 1-4(g) requires that the non-real-estate items be valued by an appraiser competent to appraise such property.

22. SR 1-5(b) requires an analysis of all sales within the last three years.

23. The IAEG requires that the appraised market value include actual physical condition and current zoning. IAEG also allows for prospective market value if the property is to be developed and the use of stabilized market value using the cap rate if the property is to be rented and occupancy will reach stabilization.

24. SR 2-2 (a & b)(viii) requires that the appraiser describe the reasoning that supports the analyses, opinions, and conclusions so intended users can understand them. In a summary appraisal, it can be in summary form. SR 2-1(b) requires that the appraiser include sufficient information for the reader to understand the report.

25. Arithmetic errors can creep in anywhere. One occasional example is when the appraiser calculates a capitalization rate on one page but use a different capitalization rate on a following page. SR 1-1(a-b) requires that the appraiser be careful not to make a significant error that would affect the credibility of the market value.

26. SWR requires that the appraiser have sound reasons for and be prepared to support the decision to exclude any information that would normally be or appear to be relevant. Under SR 2-2(a-c)(viii), the appraiser must state why he or she has been unable to obtain the information required by SR 1-5 and 1-6 or why it is irrelevant.

Notes

(1) If you do not have a copy of the current USPAP, visit www.appraisalfoundation.org, click on USPAP/Standards, Links, 2006 Uniform Standards of Professional Appraisal Practice, then click on and print each section that you want. Among the choices is a discussion of the July 1, 2006 changes.

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